Society of Actuaries

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Update on International Accounting, March 2004

by William Hines

The recent activity around International Financial Reporting Standards (IFRS) has been intense. This article will describe each of the following events that have occurred in the last month or that are imminent:

- IASB approves issuing IFRS 4 to be released on March 31, 2004
- EU Commission needs to vote on adopting IFRS 4 and IAS 32 and 39
- IASB creates European financial institution advisory group
- IAA to expose draft actuarial guidance McCrossan outlines issues for actuaries' professional responsibility
- Penrose report calls actuaries to task for insurer failures
- U.K. government asked to look at alternative regulation of actuarial profession

IASB Approves IFRS 4 for Issue

In a very close vote, the IASB approved IFRS 4, Insurance Contracts, for issuance. Released on March 31, 2004, this standard governs the financial reporting of insurance contracts. It amends other certain IASB standards to make the definitions of insurance contracts consistent with IFRS 4, and to provide guidance on application of IASB standards to certain non-insurance contracts and the treatment of embedded derivatives. IFRS 4 is to be effective starting in 2005. While it is meant to be an interim standard, it will remain in place until the IASB has finalized its ultimate solution to insurance accounting. IFRS 4 concerns insurers because it couples FAS 115-style asset treatment with current book value liabilities. As a result, there is a mismatch that will result in volatile fluctuations in reported income and/or equity. This same mismatch exists under U.S. GAAP, but the change in amortization of DAC or shadow DAC caused by changes in the market value of assets serves to substantially dampen the impact of those changes.

The IASB has introduced shadow accounting adjustments that will mitigate some of the mismatch effects for insurers that use liability systems (including DAC as a contra liability) to reflect unrealized gains or losses. The IASB has also introduced a "current interest rate option" that can be used to adjust actuarial liabilities, which has the potential to substantially reduce the mismatch problems.

EU Commission to Vote on IASB Standards

It remains to be seen if the EU will adopt IFRS 4, since additional changes have been requested by the EU. In a speech to the Institute of Chartered Accountants in England and Wales in early March, the EU Commissioner asked the IASB to rethink its position. The EU Commission is charged with approving each IASB standard after receiving a recommendation from the European Financial Reporting Advisory Group (EFRAG). EFRAG is likely to give its recommendation during mid-March and, since its members were divided at the time of writing this report, it is a very real possibility that EFRAG will recommend against adopting IFRS 4 and against adopting the revised versions of IAS 32 and 39. The key issue for IFRS 4 is the potential mismatch between the methods used to value insurance contract liabilities in IFRS 4 and those used to value the assets that back those liabilities in IAS 39. The other key issue of concern in the EU is the accounting for macro-hedging of banks under IAS 32 and 39.

IASB Creates Financial Institutions Advisory Group

Senior officials from European banking, securities and insurance regulators and from the accounting, banking and insurance industries have been asked to form a high-level European consultative group to advise the IASB. The group will focus specifically on certain basic long-term issues related to the application of accounting standards to financial institutions, which center predominantly on the application and extent of fair value accounting appropriate for regulated financial institutions in the banking and insurance industries.

While acknowledging this new group, EU Commissioner Fritz Bolkenstein has called on the IASB to work on finding acceptable temporary solutions to the critical issues related to accounting in the banking and insurance

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industries. "I have urged Sir David Tweedie to continue working in the short term with technical experts—around the clock if necessary—to try to find such appropriate solutions. One of the problems we have, unfortunately, is

a lack of trust between the interested parties. Due process has not been optimal so far and must improve in future."

IAA to Expose Draft Guidance

A subcommittee of the IAA Insurance Accounting Committee has been working to develop guidance for actuaries involved in financial reporting under IFRS. It is expected that draft guidance will be exposed to IAA members in April with a six-month exposure period. A report of the subcommittee deliberations will be discussed at the June IAA meeting in Stockholm. Guidance is expected to cover both investment and insurance contracts issued by insurers. The March newsletter of the IAA will include more background on the process.

Professional Actuarial Issues related to Accounting Standards

In a speech at the recent Global Association of Risk Professionals (GARP) Conference, Paul McCrossan, the International Actuarial Association's representative to the IASB, outlined potential issues the actuarial profession should consider with the adoption of the IASB's new accounting standards. The primary issue involves the expected mismatch between how insurers using IFRS will account for insurance liabilities and the assets backing those liabilities. Under IFRS 4, insurance liabilities will be valued according to local accounting guidance. In the vast majority of the world, local accounting guidance prescribes methods that are akin to amortized cost valuation. Under IFRS, insurer financial assets will be accounted for using IAS 39, the requirements of which are very similar to a combination of FAS 115 and FAS 133 from U.S. GAAP accounting. As under U.S. GAAP, the ability to hold assets at amortized cost is severely restricted, and thus most will have to be carried at fair value in the balance sheet. The result is that either equity or earnings, or both, will potentially exhibit volatility purely as a consequence of the accounting mismatch between the valuation of assets and liabilities. McCrossan questions whether financial reports created under IFRS involving such mismatch are, in fact, misleading. What obligation does the actuarial profession have to the public interest to not provide misleading information or to disclose when information that is provided may be potentially misleading? A follow-up report was written for the March bulletin of the Canadian Institute of Actuaries.

Penrose Report

A government report focusing on the problems at the U.K. Equitable Life was issued on March 8, two and a half years after the government ordered an inquiry. At the center of the problems are participating products known as "with-profits" and the writing of annuitization guarantees in such products. The report concludes Equitable Life overpaid bonuses to with-profits contracts and ran its business in an "uncommon, even unique" way. Equitable Life was closed to new business on December 8, 2000.

While placing primary blame for Equitable Life's problems with company management and complacency on the part of the regulator, the Penrose report criticizes the U.K. actuarial profession for not setting appropriate performance standards in its guidance issued to appointed actuaries. Actuaries in the United Kingdom have no legal standing to prevent a company from any course of action, but the appointed actuary does have an obligation to report to the regulator situations that he or she judges potentially detrimental to policy

holders. Although the legal responsibility to regulate and monitor the actions of insurance companies and the appointed actuary lies with the regulator, Penrose nonetheless concludes that the actuarial profession should have done more to prevent Equitable Life's problems.

The implication of the Penrose report is clear—all actuaries are supposed to work in the public interest and, in this case, Penrose believes that the profession was found wanting.

U.K. Government Calls for Inquiry

The U.K. government has responded to the Penrose report by requiring, among other things, a review of the actuarial profession to "consider what professional and/or other regulatory framework would best promote recognized, high-quality and continuously developing actuarial standards, openness in the application of actuarial skills, transparency in the professional conduct of actuaries, accountability for their actions and an open and competitive market for actuarial advice in the U.K."

While this is currently a national issue, there may well be implications for the actuarial profession in Europe and beyond. Self-regulation of the actuarial profession is at stake and, more importantly, so is the long-term role of actuarial professionals. Very recently, U.S. accountants, a much larger profession, lost self-regulation following Enron and other "accounting scandals." The Faculty and Institute of Actuaries regard the Penrose report and subsequent investigation as very serious and are working hard to respond on behalf of the profession.

Conclusion

Clearly the activity regarding IFRS has been intense and the consequences are great. With the increasing globalization of the financial services industry, it is essential that actuaries understand issues arising in other jurisdictions. This is especially true for actuaries operating in the financial reporting arena. The accounting and actuarial standards that will govern how we operate tomorrow are under development today. □

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